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OCT 14 1998

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

October 14, 1998

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, DC 20554

RE: CC Docket No. 98-141– Proposed merger of SBC and Ameritech.

Dear Ms. Salas:

Attached is a copy of comments by Citizens for a Sound Economy Foundation to be placed in the above referenced proceeding.

In accordance with Commission rules, a total of nine copies are attached. Please copy one to each of the commissioners.

Sincerely,

K. Lassman

Kent Lassman
Regulatory Policy Analyst

Att:

The Voice of Consumers for Free Enterprise

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BEFORE THE

FEDERAL COMMUNICATIONS COMMISSION

WASHINGTON, D.C. 20554

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OCT 14 1998

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of	)	
	)	
Merger of SBC Communications, Inc.,	)	CC Docket No. 98-141
	)	
and	)	
	)	
Ameritech Corporation	)	

Comments of Citizens for a Sound Economy Foundation

Citizens for a Sound Economy Foundation is a 501(c)3 nonprofit and educational foundation with more than 250,000 members and supporters nationwide. We take a strong interest in the SBC-Ameritech merger because we believe that all consumers are best served by a competitive, deregulated telecommunications market rather than the old system of government-enforced monopolies.

CSE Foundation believes that consumer welfare should be the principal criterion guiding all regulatory decisions. This belief stems from a fundamental assumption, common in mainstream economic analysis, that the purpose of an economic system is to satisfy the most highly-valued desires of consumers. This gives our analysis of the proposed merger a sharp focus, as we do not believe that other miscellaneous "public interest" considerations should be permitted to outweigh consumer welfare considerations. But even if the Federal Communications Commission (Commission) is willing to sacrifice a measure of consumer welfare to advance other statutory or regulatory goals, our comments should be helpful in identifying the likely impact of this merger on consumers.

After reviewing the SBC-Ameritech filing of July 24, 1998, as well as other relevant economic literature, we conclude that the merger enhances rather than retards consumer welfare, and thus should be permitted. In particular, we believe the evidence shows that:

- The merger reflects fundamental changes in the telecommunications market,
- The merger poses no threat of monopolistic abuse, and,
- The merger could deliver large consumer benefits.

I. THE MERGER REFLECTS FUNDAMENTAL CHANGES IN THE TELECOMMUNICATIONS MARKET

Fundamental changes in the international economy, along with changes in the nature of work and personal lifestyles, are leading consumers of all types to demand new and improved services from telecommunications companies.

"Globalization" has now become a buzzword in policy and business circles. Beneath the hype are important realities that telecommunications companies and regulators ignore at their own peril. As people conduct a greater portion of their business on an international (or even national) scale, they have a greater need for voice, data, and video communications that connect them with the people with whom they do business. In addition, the ubiquity of business travel means that employees of businesses with national or global reach have a greater need to keep in touch with both their families and their home office when they are on the road. These factors increase consumers' desire for high-quality, easy-to-use, seamless telecommunications services.

Another factor altering the telecommunications marketplace is a change in the nature of work itself.[1] Numerous commentators have recognized the emergence of a "post-industrial" economy in which human brainpower replaces a great deal of physical labor.[2] People whose primary work deals with ideas, formulas, words, and symbols need to be able to ship their product and works-in-progress to others; this need has contributed to an explosion of business demand for bandwidth to handle data and video transmission.

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[1] See Peter F. Drucker, "Management's New Paradigms," (Forbes, Oct. 5, 1998) pages 152-177. What Drucker asserts as a general rule for the management of knowledge workers may be applied to telecommunications regulation as well: "[E]very seasoned executive has learned, few policies remain valid for as long as 20 to 30 years. Nor do most assumptions about the economy, about business, about technology remain valid longer than that."

[2] See Alvin Toffler, *The Third Wave* (New York: Bantam, 1989); Alvin and Heidi Toffler, *Creating a New Civilization* (Atlanta: Turner Publishing, 1995).

The rise of "mind work" has also increased the demand for many types of telecommunications services because mind work lends itself much more readily to telecommuting and home-based work. Whereas physical labor usually ties workers to a particular location, much mind work can be performed anywhere. Whether they are motivated by a desire to stay home and care for family members, to live in a more pleasant location, or simply to avoid a grueling daily commute, employees, entrepreneurs, and contractors alike can now work outside of "the office" all or part of the time.

For these reasons, distinctions based on consumer location are breaking down. Territorial monopolies for local phone service are an impediment to serving multi-location customers who want to contract with one provider for all of their telecommunications needs. The traditional distinction between "business" and "residential" consumers also makes little sense in an era where mind work in the home is common.

These economic changes suggest that there is a significant need for telecommunications companies that can offer a combination of voice, data, and video services, anywhere that mind workers are likely to be. Therefore, one successful business strategy would combine a wide scope of services with national or international reach.

This approach is at odds with the structure of many aspects of the current telecommunications market. Pre-1996 regulation balkanized the marketplace by product line, preventing the local Bell companies from offering long-distance service and preserving telephone and cable television as separate markets. (Even the provisions of the 1996 Telecommunications Act temporarily preserve some aspects of this balkanization in the name of preventing monopolistic abuses by the local telephone companies.) Pre-1996 regulation also balkanized the industry geographically, often preventing multi-location customers from contracting with a single firm for all of their local telephone service. And to this day, regulation still fragments the industry by consumer segment, enforcing an artificial distinction between "residential" and "business" consumers in an attempt to funnel hidden subsidies to the former from the latter.[3]

In this context, the SBC-Ameritech merger and associated business plan represent a clear attempt to respond to consumers' new desires in the contemporary telecommunications market.[4] No doubt, those that have an interest in the preservation of the old, heavily regulated, and artificially fragmented market will fight the merger. CSE Foundation believes that the Commission should brush aside such self-interested criticisms and permit the merger to proceed.

II. THE MERGER POSES NO THREAT OF MONOPOLISTIC ABUSE

This merger involves virtually no downside risk for consumers. With a few exceptions that will be dealt with through divestiture, SBC and Ameritech do not compete in each other's service territories and have no plans to do so. There is no evidence that they could achieve the same efficiencies as independent companies, and there is plausible evidence that the merged firm will be a more effective competitor. Finally, even if the merger somehow created a degree of market power, the inherent dynamism of the telecommunications market protects consumers from long-run harm.

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[3] To appreciate the futility of this distinction, note that a busy executive who phones her doctor from the office is considered a "business" customer, but she is considered a "residential" customer when she performs a Web search from home to get data for a business report.

[4] We do not mean to imply that the SBC-Ameritech strategy is the only possible successful strategy in the new telecommunications market. There will likely also be a continued need for niche players who earn business from particular groups of consumers due to their superior knowledge of those consumers' needs.

Where do SBC and Ameritech compete?

The St. Louis and Chicago wireless markets are the only places where SBC and Ameritech compete substantially.[5] They plan to divest one of each of the overlapping licenses to a third party, so there will be no reduction in the number of actual, independent competitors in these markets.

Would SBC and Ameritech have expanded their competition in the absence of the merger?

In previous merger decisions, the Commission noted five elements must be satisfied to demonstrate that two companies are actual potential competitors:

1. The market in question is highly concentrated.
2. Few other potential entrants are "equivalent" to the company that proposes entering the market through the merger.
3. The company entering the market by merger would have entered on its own but for the merger.
4. That company had other feasible means of entry.
5. The alternative means of entry had a substantial likelihood of succeeding and deconcentrating the market.[6]

Of the markets under consideration, only one -- the market for local exchange service -- is clearly concentrated. While the long-distance market is dominated by three large carriers -- AT&T, MCI, and Sprint -- there is also a large fringe of resellers, and

But it seems clear that there will always be room in the market for a number of companies offering a wide scope of services combined with an international reach.

[5] SBC-Ameritech Application at 58.

[6] *In Re Pacific Telesis and SBC Communications* (Jan. 31, 1997), para. 18; *In the Applications of NYNEX and Bell Atlantic* (Aug. 14, 1997), para. 138.

competition is vigorous.[7] The market for data transmission is even less concentrated when one considers the number of substantial competitors that haul data on their own networks, in addition to the long-distance phone companies. The wireless market is now open to a large number of competitors, in part due to the auction of new PCS frequencies.

It is reasonable to assume that only a limited number of companies possess the abilities, personnel, brand name recognition, and know-how to compete in local telephone service. Following the Commission's analysis in *Pacific Telesis-SBC*, we can safely count the other Bell operating companies, AT&T/TCI, Sprint, MCI, LDDS, Cable & Wireless, and Time Warner among the actual potential competitors in the local markets of SBC and Ameritech.[8]

Some might be tempted to severely limit the list of actual potential competitors, based on a narrow reading of the Commission's analysis in the NYNEX-Bell Atlantic merger. In *NYNEX-Bell Atlantic*, the principal markets of concern were New York City and northern New Jersey -- two large markets on the border between the two companies. In that case, the Commission identified five actual potential competitors who already possessed not just expertise, but also facilities and significant brand-name recognition in these markets: Bell Atlantic, NYNEX, Sprint, AT&T, and MCI. Significant movement of people between these two markets, combined with the potential for broadcast media advertisements to reach both markets simultaneously, made NYNEX and Bell Atlantic plausible potential competitors. However, New York City-New Jersey is a unique market. The only possibly similar market area involved in the instant merger is St. Louis

[7] One of the most recent and exhaustive analyses of competition in the long-distance market concluded that there is substantial competition in both the interstate inter-LATA and intrastate inter-LATA markets, although not perfect competition. The authors cite rate regulation as the main reason this market has not been more competitive. See Robert Crandall and Leonard Waverman, *Talk is Cheap* (Washington, D.C.: The Brookings Institution, 1995) at 158-65.

and East St. Louis, but it is quite a stretch of the imagination to view these markets as comparable to New York City-New Jersey.

Even if one chooses to view these markets as analogous, geography suggests several additional potential competitors that were not present in *NYNEX-Bell Atlantic*. The service territories of two other regional Bells – BellSouth and US WEST – border both Illinois and Missouri. Due to their proximity, these companies have just as good a claim to be potential entrants in Illinois as does SBC, and they have just as good a claim to be potential entrants in Missouri as does Ameritech. As local exchange carriers, both companies possess a set of advantages that could make them credible competitors.

Finally, even if the Commission decides that the SBC-Ameritech merger significantly increases concentration in local exchange service, there is no evidence that either company plans to enter the other's territory. SBC explored the possibility of offering local telephone service outside of its region, but market trials proved disappointing, and the company decided to focus its attention elsewhere.[9] Ameritech tried selling local service bundled with cellular service in St. Louis, but has had little success and put the project on hold.[10] Since the companies have no plans to compete with each other in local service and perceive no effective means of doing so, the merger does not eliminate an actual potential competitor in either's territory.

Would two separate companies be more effective competitors?

Analysis of this merger is complicated by the fact that SBC and Ameritech propose not just to merge, but also to expand into 30 additional markets to become a national provider of local, long-distance, and data services. Fortunately, the Applicants

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[8] *Ibid.*, para. 24.
[9] Sigman Affidavit.

provided a list of prospective benefits that they expect to accrue from the merger, separate from the national-local strategy. Thus, it is possible to ask whether they could, as separate companies, achieve the benefits attributed directly to the merger, and then also ask whether either would pursue the national-local strategy in the absence of the merger.

Is the merger necessary to produce the projected direct benefits?

The Applicants list a large number of expected cost savings and increased sales opportunities. The principal sources of these savings are economies of scale and scope, and wider diffusion of best practices and other knowledge across the organization.

In theory, two separate companies could enjoy many of the economies of scale and scope that the merger attempts to achieve. They could do so by hiring each other to perform certain functions where economies of scale and scope are present, or by contracting out to independent service firms who would sign up enough businesses as clients to take full advantage of any economies of scale or scope. Indeed, the move toward such market-like arrangements is growing both within and between companies.[11]

However, there are limits to the extent to which firms can contract with outsiders to supply various services. To the extent that the services require transaction-specific investments, contracting in advance over all contingencies may become too costly, and integration through a merger may provide a superior method of governing the transactions.[12] In addition, the quality of services as well as the ease of contract administration may vary depending on whether the service provider shares the same "corporate culture" as the purchaser. Corporate culture helps to define the boundaries

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[10] Osland Affidavit; Weller Affidavit, paras. 31-33.

[11] See William Halal, Ali Geranmayeh, and John Pourdehnad, *Internal Markets* (Wiley, 1993); Russell Ackoff, *The Democratic Corporation* (Oxford, 1994); Jerry Ellig, "Internal Markets for Corporate Services," Center for Market Processes Working Paper (1992).

[12] Oliver Williamson, *The Economic Institutions of Capitalism* (Free Press, 1985).

between permissible and impermissible behavior, and it also conveys difficult-to-articulate knowledge about the needs of internal customers.[13] For these reasons, service provision by internal units may involve higher quality and lower communication and transaction costs. It then follows that a merger plausibly offers the most efficient way that SBC and Ameritech can capture economies of scale and scope in many internal functions.

Diffusion of best practices and other significant knowledge may also be best accomplished through a merger. The reason is that knowledge possess some unique attributes that make it difficult to sell across company boundaries. Knowledge is subject to a well-known paradox: a buyer has difficulty evaluating what a piece of knowledge is worth until he knows what it is, but once the seller shows the buyer the knowledge, the buyer now has access to it without having paid for it. Separate firms could write contracts that prevent the buyer from using the knowledge until he has paid, but if such contracts are costly to write or enforce, it may be less expensive for the two firms to merge, so that the knowledge is kept inside the boundaries of the same organization.[14] In addition, transfers of knowledge across organizations are often difficult because people in different organizations use different "mental models" to understand the markets and opportunities they face.[15] When dealing with knowledge transactions, people in one firm may actually have trouble understanding what people in another firm are asking for or

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[13] Colin Camerer and Ari Vepsalainen, "The Economic Efficiency of Corporate Culture," *Strategic Management Journal* 9 (1988), pp. 115-26; Jerry Ellig, "Internal Markets and the Theory of the Firm," *Managerial and Decision Economics*, forthcoming.
[14] David J. Teece, "Economies of Scope and the Scope of the Enterprise," *Journal of Economic Behavior and Organization* 1 (1980), pp. 223-47.
[15] Peter Senge, *The Fifth Discipline* (New York: Doubleday, 1991).

telling them.[16] Over time, the people working for two merged firms can develop similar mental models and corporate cultures, lowering the cost of communication.

Is the merger necessary for the national-local strategy?

Prior to the proposed merger, neither SBC nor Ameritech planned anything like the proposed national-local strategy. On the contrary, each engaged in a few trial efforts at selling local service outside their service areas and quickly abandoned the idea.[17]

It appears that a crucial ingredient in making the strategy succeed is a large base of multi-location customers in the home territory, plus rapid entry into numerous markets outside the home territory. In their combined home territories, SBC and Ameritech have more large, multi-location customers that either has individually. SBC already serves 11 of the nation's largest telecommunications markets, and Ameritech serves nine, so that the merged company need only expand into 30 additional cities to cover the 50 largest metropolitan statistical areas in the country. Thus, a combined effort has a much larger chance of success, since it starts with more prospective customers and less construction of new facilities than either company would have if it attempted the national-local strategy individually.[18]

The Applicants make a strong case that neither has enough experienced managerial employees to staff the proposed expansion. The companies expect to have 8,000 employees devoted to the new markets within 10 years.[19] Of that number, 2,850 would be managers – a number equal to 8 percent of the combined companies' current managerial workforce. If SBC tried the national-local strategy on its own, it would need

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[16] Richard N. Langlois and Nicolai J. Foss, "Capabilities and Governance: the Rebirth of Production in the Theory of Economic Organization," Manuscript (Nov. 5, 1996).
[17] SBC-Ameritech Application at 491.
[18] Kahan Affidavit, paras. 48-54.

to employ 3,515 managers in new markets (16 percent of its current managerial labor force). If Ameritech tried the national-local strategy on its own, it would need to employ 4,085 managers in new markets (36 percent of its current managerial labor force).[20] Clearly, the two companies together can better handle the national expansion because their merger both reduces the number of new markets to enter and increases the pool of managers available to deploy.

We do take issue with Applicants' argument that the merger is necessary because neither company alone could bear the earnings dilution that the national-local strategy would entail.[21] According to this view, capital markets evaluate stocks of local exchange carriers like SBC and Ameritech based primarily on earnings rather than future growth prospects. The heavy negative cash flows associated with the national-local strategy would severely depress earnings, presumably depressing stock prices and making it more difficult or expensive for a single company to attract equity capital.

The earnings dilution argument appears to be based on a highly questionable assumption of inefficiencies in American and global capital markets. It may well be the case that financial markets currently evaluate local exchange carriers' stocks based on earnings (and dividend flows), because regulation has historically limited these carriers' ability to diversify into high-growth markets. However, it does not then follow that investors will continue to use the same criteria to evaluate a local exchange carrier that publicly announces a significant and credible new strategy for nationwide expansion and obtains the regulatory approvals necessary to do so. The more likely scenario is that

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[19] Kahan Affidavit, para. 22.
[20] Carlton Affidavit, Table 2.
[21] SBC-Ameritech Application at 51; Weller Affidavit, para. 34; Kahan Affidavit, paras. 79-80.

financial market participants will incorporate this new information into their evaluations of the company, and begin to apply growth-company criteria in their evaluations. The *composition* of investors may well change as growth investors buy shares and investors who want a safer haven for their funds switch into other utility stocks. But there is little reason to believe that investors – particularly growth investors – would willfully ignore information that they have a strong interest to notice.

SBC itself admits that it is capable of raising the capital needed for the national-local strategy as a stand-alone company.[22] In addition, the behavior of SBC's own stock price suggests that capital markets will take notice when a local exchange carrier transforms itself into a growth company. SBC is known as one of the more aggressive, growth-oriented local exchange carriers. As a result, its stock trades at a higher earnings multiple than BellSouth, Ameritech, Bell Atlantic, and US WEST, and the latter three companies offer higher dividend yields.[23] Recent media coverage of the electric utility industry, which is not yet nearly as deregulated and competitive as the telecommunications industry, also suggests that investors do indeed change their evaluation criteria as a company's strategies and opportunities change. A recent *Wall Street Journal* article urged investors to judge utilities by the same criteria used to evaluate other companies. A fund manager quoted in the article advised, "[t]ry to understand as well as we can which utilities excel in what businesses, and which managements are best able to judge the new environment."[24]

Although the earnings dilution argument is implausible, some of the other dilution-oriented arguments put forth by the applicants make more sense. It should be

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[22] Kahan Affidavit, para. 75.
[23] Based on price to earnings and yield data reported in *The Wall Street Journal* (Oct. 1, 1998).

intuitively obvious that the merged SBC-Ameritech can draw on a larger pool of experienced executives to staff the expansion. In addition, the merged firm will have established business relationships with a larger number of large, multi-location customers, which may make rapid national expansion more viable. For these and numerous other reasons presented in this Comment, we believe the Applicants have made a strong case for the merger even in the absence of the earnings dilution argument.

Market dynamism mitigates market power.

Market concentration provides an especially misleading picture of the state of competition in the presence of rapid change. If costs are falling or quality attributes are improving rapidly over time, even incumbent firms in highly concentrated industries face substantial competitive pressures. If they are to retain their dominant position, the incumbents must continually improve their price and/or quality of service.[25]

In suggesting that market dynamism mitigates market power, we do not mean to argue that barriers to entry, in the form of sunk costs, are low or nonexistent. We are not attempting to invoke the theory of contestable markets.[26] Our argument makes a different

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[24] Linda Sandler, "Beyond Dividends," *The Wall Street Journal* (Sept. 14, 1998) at R15.

[25] David J. Teece and Mary Coleman, "The Meaning of Monopoly: Antitrust Analysis in High Technology Industries," *Antitrust Bulletin*, forthcoming.

[26] The theory of contestable markets, which rigorously examines the role of sunk costs in deterring entry, asumes a world of perfect information and no innovation. It simply does not deal with a world in which entrants or incumbents might have access to superior technology or other superior resources. The principal developer of the theory notes:

> [P]erfect contestability, again like perfect competition, threatens to rule out entirely the reward mechanism that elicits the Schumpeterian innovative process. This mechanism ... rests on the innovator's supernormal profits, which are permitted by the temporary possession of monopoly power flowing from priority in innovation. Since perfect contestability rules out all market power, that is, since it permits immediate entry of imitators of any innovation, the market mechanism's main reward for innovation is destroyed by that market form. In short, it is clearly no panacea that can bring dynamic and static efficiency at the same time.

See William J. Baumol and Janusz A. Ordover, "Antitrust: Source of Dynamic and Static Inefficiencies?" in Thomas M. Jorde and David J. Teece, *Antitrust, Innovation, and Competitiveness* (N.Y.: Oxford, 1992);

point: The more rapid the pace of change, the easier it is for entrants to leap over the barriers to entry thought to benefit the incumbents, even if entry involves substantial sunk costs. Faced with such competitive pressures, incumbents have stronger pressures to perform than the statistics on market concentration or a measurement of sunk costs would lead one to believe.

To take the most direct example: All Bell companies are currently thought to benefit from the enormous sunk cost created by their network of copper wires. A number of technology forecasters, however, believe that the cost of these copper wires will soon become an unrecoverable albatross around the incumbent local exchange carriers' necks, rather than a barrier to entry that protects profits. One suggests that the cost of wireless calls could fall to 5 cents per minute within five years, and local exchange carriers could lose up to 50 percent of their calling revenues within 10 years as a result of lower-cost competition from both the wireless and cable industries.[27]

Evidence exists that even local telephone service, the most concentrated market at issue in this proceeding, is capable of delivering substantial improvements in price performance as a result of continuous improvement and technological change. Consider, for example, the changes in the monthly price of local service in the 10 years following the breakup of AT&T. Many observers feared that the breakup, combined with the Commission's implementation of the Subscriber Line Charge to reduce the subsidy flowing from long-distance to local service, would result in significant price increases. The subscriber line charge did raise the price of basic local service by a few dollars per

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William Baumol, John Panzar, and Robert Willig, *Contestable Markets and the Theory of Industry Structure* (New York: Harcourt Brace Jovanovich, 1982).

[27] G. Christian Hill, "Consultant's Call," *The Wall Street Journal* (Sept. 21, 1998) at R27.

month in the mid-1980s. By 1994, however, the real price of basic local service was about where it was in 1984, the year of the AT&T breakup. By 1994, real average local rates, including the subscriber line charge, actually fell by 13 percent from their 1986 peak. (See the accompanying table.)

Real Monthly Local Telephone Rates (In 1995 Dollars)

1984	$19.58
1985	20.59
1986	22.43
1987	22.35
1988	21.35
1989	21.54
1990	20.74
1991	20.88
1992	20.31
1993	19.85
1994	19.54

Source: Robert Crandall and Jerry Ellig, *Economic Deregulation and Customer Choice* (Fairfax, Va.: Center for Market Processes, 1997).

Productivity growth is the "magic" that made it possible for local exchange carriers to lower their own rates by a large enough amount to offset the subscriber line charge. A number of industry experts believe that local exchange carriers can achieve productivity increases of between 5 percent and 7 percent per year.[28] This Commission has itself recognized the potential for ongoing improvement, through its choice of a 6.5 percent productivity offset for the price cap on local access charges.[29]

[28] Peter K. Pitsch, *The Innovation Age* (Hudson Institute and Progress & Freedom Foundation, 1996), p. 99. For further study of telecommunications mergers in the Innovation Age, see also, Peter K. Pitsch, "An Innovation Age Perspective on Telecommunications Mergers," Citizens for a Sound Economy Foundation, *Issue and Answers* (Nov. 13, 1996) No. 43.

[29] In May 1997, the Commission set a productivity factor, or "X-Factor," for access charges at 6.5 percent less the amount of inflation. See Report No. CC 97-22.

If these kinds of productivity gains are indeed possible, they serve as a counterweight to market power, for two reasons. First, as the Commission has recognized, to the extent that rapid increases in productivity reduce marginal costs, even a firm with market power has an incentive to lower its prices and, or, improve the quality of service.[30] Second, the existence of large productivity gains also allows us to infer something about the prospects for rapid change in the market. A market with rapid productivity increases surely qualifies as more dynamic than a market with slow productivity increases. The more dynamic the market, the more vulnerable incumbent firms are to potential competitors.

For these reasons, the local exchange market may face more competitive pressure than concentration statistics or measures of sunk costs would imply.

III. THE MERGER COULD DELIVER LARGE CONSUMER BENEFITS

Principal benefits claimed by the companies.

The Applicants project that their merger will produce a number of substantial benefits. Projected cost savings include $1.17 billion in expenses and $260 million in capital expenditures. They also project a revenue gain of $778 million, largely through the adoption across companies of best practices in marketing and sales.[31]

The cost savings are not guaranteed, but they seem plausible given SBC's previous experience with the Pacific Telesis merger. We also agree that the $778 million should count as a consumer benefit. Because the figure assumes no price increases, it simply represents the value consumers attach to services that they would not have bought if the merger had not led to the adoption of best marketing and sales practices. As a

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[30] *In the Applications of NYNEX and Bell Atlantic* (Aug. 14, 1997), para. 169.
[31] Kaplan Affidavit.

matter of economic theory, the $778 million figure is actually a lower-bound estimate of consumer value, because consumers must receive a bundle of services worth more than $778 million if they are to be motivated to make the exchange.[32]

We do take issue with one of the alleged benefits of the merger. The Applicants briefly suggest that the merger can be expected to create jobs, based on the job growth experienced at Pacific Telesis following the SBC-Pacific Telesis merger.[33] From an economic perspective, however, the creation of jobs is a cost -- not a benefit.[34]

The benefits of economic activity are the satisfaction of human desires by the goods and services produced; one of the associated costs is that people have to work to produce the goods and services. The most advantageous system of all would be one in which every member of society could obtain all of the valuable products and services he or she could use without working. There would be no jobs, but our standard of living would be quite high, since we would have plenty of goods and services, plus a lot of leisure time.

Conversely, it is also possible to imagine a society with plenty of jobs but a low standard of living. A society in which everyone simply dug holes in the ground only to fill them back up again would have full employment, but would produce little of value to consumers, and the standard of living would be quite meager. If the Applicants really want to offer job creation as a benefit of the merger, they should propose to hire 10,000 people to dig holes and to fill them back up again!

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[32] In economic jargon, the company must leave consumers with at least a little bit of "consumer surplus" in order to motivate the purchases.
[33] SBC-Ameritech Application at 42; Kahan Affidavit, para. 94.
[34] See, for example, Richard McKenzie, *The Great American Job Machine* (New York: Universe, 1988).

It would be much better if the Applicants could produce all of the savings and business expansion they project without hiring any more employees, for then the cost to consumers would be lower than would otherwise be the case. Of course, this is probably not possible, and we do not begrudge anyone an employment opportunity that produces something that consumers value. But we remain wary of claims that a merger that creates jobs is inherently good, along with the implications that a merger that creates more jobs is even better, and a merger that reduces jobs is bad.

How much of these benefits will flow to consumers?

The answer to this question depends on the particular type of market under consideration. The effects of the merger on consumers might be different in competitive and in regulated markets. In addition, the merger creates opportunities for interactions across different kinds of markets that could enhance competition.

Competitive markets.

It is well-recognized that competitive markets force firms to pass the benefits of improved efficiency through to consumers. However, a careful distinction must be made to understand how competition works in real markets as opposed to textbook theory.

In the textbook model of competition, the presence of numerous identical firms, none of which possess a cost or quality advantage, assures that all efficiency gains accrue to consumers, and all firms earn only a "normal" rate of return equivalent to what investors' capital would earn in its next best alternative use.[35] In real markets, firms are differentiated, and individual firms often possess unique cost or quality advantages. Competition forces the most efficient firm to offer consumers a combination of price and quality at least as good as that offered by the next most efficient rival. The cost savings or other efficiency benefits created by the most efficient firm are thus never fully passed through to consumers; the firm earns superior profits that reflect its superior efficiency.[36] A great deal of scholarly research suggests that such firm-specific effects contribute much more to corporate profitability than monopoly rents generated by market structure.[37]

These profits, and the absence of a 100 percent pass-through, do not indicate monopolistic exploitation. They are simply a reward earned by superior firms that promotes continuous improvement. Over time, consumers reap larger benefits by allowing firms to keep this reward than by expropriating it. For this reason, we caution the Commission to avoid inferring that markets are not competitive in the absence of a 100 percent pass-through of efficiencies to consumers.

Regulated markets.

In most regulated markets, such as local exchange and exchange access service, SBC and Ameritech are subject to some form of price cap regulation. (See accompanying table.) Under price cap regulation, there is no guarantee that all of the efficiencies created by this merger will immediately be passed through to consumers.

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[35] See, e.g., Hal Varian, *Microeconomic Analysis*, 2nd ed. (New York: W.W. Norton, 1984) at 82-85.

[36] Shelby D. Hunt, "The Resource-Advantage Theory of Competition," *Journal of Management Inquiry* 4:4 (December 1995), 317-32; Shelby D. Hunt and Robert M. Morgan, "The Comparative Advantage Theory of Competition," *Journal of Marketing* 59 (April 1995), 1-15; Robert Jacobson, "The 'Austrian' School of Strategy," *Academy of Management Review* 17:4 (1992) , 782-807; Harold Demsetz, "Industry Structure, Market Rivalry, and Public Policy," *Journal of Law and Economics* 16 (1973), 1-10. Note that the superior firm may have some measure of market power; it could charge a price that allows it to earn only a normal rate of return, but instead it chooses to charge a price just sufficiently low to garner business at the expense of the next most efficient competitor.

[37] See Richard P. Rumelt, "How Much Does Industry Matter?" *Strategic Management Journal* 12 (1991), pp. 167-185. Rumelt estimated that industry and firm effects accounted for 8 percent and 46 percent, respectively, of a firm's profit variability. Also see Jaime A. Roquebert, Robert L. Phillips, and Peter A. Westfall, "Market Versus Management: What 'Drives' Profitability," Working Paper, Texas Tech University. Roquebert, et. al. used a much larger data set, sampling from more industries and firm sizes, and found industry and firm effects to be 10 percent and 57 percent, respectively.

State With Price Cap Regulation of Ameritech and SBC

State	Inflation Index	Productivity Offset	Year Effective	Other
Arkansas	75% of GDP-PI	None	1997	
California	GDP-PI	5%	1994	Rate freeze thru 1998
Illinois	GDP-PI	4.3%	1994	Up to 2% penalty for poor service
Indiana	None	None	1994	Rates capped
Kansas	None	None	1990	Rates frozen
Michigan	Detroit-area CPI	1%	1995	
Missouri	None	None	1994	Rates frozen thru 1998
Nevada	None	None	1995	Prices frozen at rates est. in rate case
Ohio	GDP-PI	3%	1995	Penalties for poor service
Texas	CPI	Set by Commission	1995	4-year rate freeze
Wisconsin	GDP-PI	3%	1994	Reward/ penalty for service

Source: National Regulatory Research Institute.

This does not, however, mean that consumers do not benefit. The purpose of price cap regulation is to give regulated firms superior incentives to reduce costs. It is an attempt to mimic the competitive process in real markets, where the most efficient firms earn a premium over the normal rate of return as a reward for their efficiency.

When price cap regulation is instituted, the regulated firm agrees to a rate freeze or a formula for rate reductions in exchange for the opportunity to earn higher rates of return if it can improve the efficiency of its operations. One possible way of improving efficiency is to engage in cost-reducing mergers, and the Applicants have documented more than $1.25 billion worth of cost savings they expect to realize. It is positively perverse to tell firms that they cannot merge because price cap regulation does not force them to pass the benefits through to consumers. Consumers already received a guaranteed benefit, in the form of the price cap, and the firm agreed to the cap so that it could profit if it found opportunities to improve efficiency. We can think of no more effective way to undermine the efficiency incentives created by price cap regulation than to prohibit firms from acting on, and profiting from, cost-reducing opportunities they identify after the price cap is in place.[38]

Even in the worst case scenario – a price cap too high to constrain a monopolist from exercising market power – the merged firms have incentives to pass the benefits of increased efficiency through to consumers if the efficiencies reduce marginal costs. The Commission itself recognized this principle in its discussion of the NYNEX-Bell Atlantic merger.[39]

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[38] "[M]andating pass-through of all claimed efficiencies would undermine the incentives our price cap rules create for carriers to become more efficient." *In the Applications of NYNEX and Bell Atlantic* (Aug. 14, 1997), para. 207.

[39] *In the Applications of NYNEX and Bell Atlantic* (Aug. 14, 1997), para. 169.

How much of the prospective savings represent a reduction in marginal costs? The answer depends on one's time frame; some costs may be fixed in the short run but marginal over a longer time period. Based on the information the Applicants provided, we have attempted to identify some categories of cost savings that likely affect short-run marginal costs, some that do not affect short-run marginal costs, and others that may contain a mixture (or are impossible to classify based on the information provided). As the accompanying table shows, approximately $283 million can probably be classified as a reduction in short-run marginal costs, and another $776 million may contain some short-run marginal cost elements.

It is also worth noting that the fact that some items do not affect short-run marginal cost does not mean that these cost reductions produce no benefits for consumers. "Costs that are fixed in the short run become variable in the long run, and thus reductions in fixed costs can result in lower prices or improved entry opportunities over the longer term."[40]

[40] Gilbert and Harris Affidavit, para. 55.

Short-run marginal cost (Total: $283 million)

- $121 million reduction in procurement expenses
- $115 million provision and maintenance
- $10 million collections
- $22 million operator services
- $15 million outside sales

Not short-run marginal cost (Total: $672 million)

- $260 million reduction in procurement (capital expenditures)
- $85 million marketing, product development, advertising
- $54 million real estate
- $45 million switching/network engineering
- $17 million network administration
- $10 million telemarketing
- $201 million administration

Mixture or not enough information to classify (Total: $776 million)

- $227 million information technology
- $24 million motor vehicle expenses
- $35 million demand sales
- $13 million pay phone
- $31 million industry markets
- $146 million other businesses
- $300 million long distance

In addition to these cost savings, one must determine whether the $778 million in new sales would count as a benefit passed through to consumers if price caps are insufficient to constrain market power. Analysis of these new sales under the standard textbook monopoly framework is problematic, because the textbook model assumes that all firms have already adopted best practices, and all customers have perfect information about the price and performance characteristics of all service options. In this framework,